[JOINT COMMITTEE PRINT]

# EXPLANATION OF PROPOSED INCOME TAX TREATY BETWEEN THE UNITED STATES AND AUSTRALIA

SCHEDULED FOR A HEARING
BEFORE THE

## COMMITTEE ON FOREIGN RELATIONS
## UNITED STATES SENATE

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## INTRODUCTION

This pamphlet provides an explanation of the proposed income tax treaty between the United States and Australia. The proposed treaty was signed on August 6, 1982. A similar treaty between the two countries, signed in 1953, is currently in force. The proposed treaty has been scheduled for a public hearing on May 24, 1983, by the Senate Committee on Foreign Relations.

The proposed treaty is similar to other recent U.S. income tax treaties, the U.S. model income tax treaty, and the model income tax treaty of the Organization for Economic Cooperation and Development (OECD). However, there are certain deviations from those documents.

The first part of the pamphlet is a summary of the applicable provisions of the proposed treaty. The second part provides an overview of U.S. tax rules relating to international trade and investment and U.S. tax treaties in general. This is followed by a detailed, article-by-article explanation of the proposed treaty.

## I. SUMMARY

### In General

The principal purposes of the proposed income tax treaty between the United States and Australia are to reduce or eliminate double taxation of income earned by citizens and residents of either country from sources within the other country, and to prevent avoidance or evasion of the income taxes of the two countries. The proposed treaty is intended to continue to promote close economic cooperation between the two countries and to eliminate possible barriers to trade caused by overlapping taxing jurisdictions of the two countries. It is intended to enable the countries to cooperate in preventing avoidance and evasion of taxes.

As in other U.S. tax treaties, these objectives are principally achieved by each country agreeing to limit, in certain specified situations, its right to tax income derived from its territory by residents of the other. For example, the treaty contains the standard tax treaty provisions that neither country will tax the business income derived from sources within that country by residents of the other unless the business activities of the taxing country are substantial enough to constitute a permanent establishment or fixed base (Articles 7 or 14). Similarly, the treaty contains the standard "commercial visitor" exemptions under which residents of one country performing personal services in the other will not be required to pay tax in the other unless their contact with the other exceeds specified minimums (Articles 14, 15, and 17). The proposed treaty provides that dividends, interest, royalties, certain capital gains and certain other income derived by a resident of either country from sources within the other country generally may be taxed by both countries (Articles 10, 11, 12, 13, and 21). Generally, however, dividends, interest, and royalties received by a resident of one country from sources within the other country are to be taxed by the source country on a restricted basis (Articles 10, 11, and 12).

In situations where the country of source retains the right under the proposed treaty to tax income derived by residents of the other country, the treaty generally provides for the relief of the potential double taxation by the country of residence allowing a foreign tax credit or, in certain cases, a partial exemption.

This treaty contains the standard provision (the "saving clause") contained in U.S. tax treaties that each country retains the right to tax its citizens and residents as if the treaty had not come into effect (Article 1). In addition, it contains the standard provision that the treaty will not be applied to deny any taxpayer any benefits he would be entitled to under the domestic law of the country or under any other agreement between the two countries (Article 1); that is, the treaty will only be applied to the benefit of taxpayers.

The proposed treaty differs in certain respects from many U.S. income tax treaties and the U.S. model. It also differs in significant respects from the present treaty with Australia.

(1) U.S. citizens who are not also U.S. residents are not generally covered. The U.S. model does cover such U.S. citizens. However, the United States has rarely been able to negotiate coverage for nonresident citizens.

(2) The proposed treaty does not provide for determination of a single residence for all corporations that are residents of both the United States and Australia under local law. The U.S. and Organization for Economic Cooperation and Development (OECD) model treaties do each provide for such a determination. The effect of the lack of such a provision in the proposed treaty is to deny certain treaty benefits to dual resident corporations. Although such corporations may under current law be able to deduct certain amounts in both countries, they would also have to include items of income in both countries. The proposed treaty might tend to encourage some dual resident companies to become residents of but one country so as to take advantage of certain treaty benefits.

(3) The definition of permanent establishment in the proposed treaty is somewhat broader than that in the U.S. model and in many existing U.S. treaties. The principal areas in which the proposed treaty departs from the U.S. model are the inclusion as a permanent establishment of a building site or construction, assembly or installation project that exists for more than 9 months and an installation, drilling rig or ship that, for at least 6 months in any 24 month period, is used for dredging or for sea-bed and subsoil exploration or mining (rather than, in each case, the model's 12 months). In addition, maintaining substantial equipment in a country for more than 12 months or engaging in supervisory activities in connection with building sites, etc. for more than 9 months in any 24 month period would create permanent establishment status under the proposed treaty but not under the model.

(4) The proposed treaty does not contain a definition of the term "business profits", although certain categories of business profits are defined in various articles. This leaves to local law the definition of that term in some cases, and accordingly the profits must be attributed to a permanent establishment before those profits can be taxed by the country where the permanent establishment is located. Many U.S. treaties, and the U.S. model, define the term business profits to include income from rental of tangible personal property and from rental or licensing of films or tapes. Absence of this definition means that persons who earn such rental or licensing income could be subject to tax on a gross basis, not a net basis, in the source country unless they maintain a permanent establishment there.

(5) The proposed treaty does not allow investors in real property in the country not of their residence to elect to be taxed on such investments on a net basis. The U.S. model allows such an election. Although current Australian law (and current U.S. law) provides for net basis taxation, there is no guarantee that Australia will continue such treatment.

(6) The proposed treaty does not exempt from source country tax certain categories of income that would be exempt under the U.S.

model treaty as shipping or aircraft income. These categories include: (1) income from leasing containers that is not incidental to the operation of ships or aircraft in international traffic by the lessor; and (2) income from leasing ships or aircraft on a full basis by persons that do not either operate ships or aircraft in international traffic or in their home country or regularly lease ships or aircraft on a full basis.

(7) The limit on the gross dividend withholding tax that the country of source may impose is 15 percent (Article 10) in contrast to the 5 percent limit on direct dividends and 15 percent limit on portfolio dividends in the U.S. model. The present treaty also allows a 15 percent rate.

(8) The withholding tax at source on gross interest is limited to 10 percent (Article 11) rather than the zero rate in the U.S. model. A zero rate is not generally achieved in many treaties, but is at times achieved for interest earned by banks on loans made into the source country. Although the present treaty does not limit the rate of the withholding tax on interest, the current Australian statutory withholding rate is 10 percent, while the analogous U.S. rate is 30 percent.

(9) The withholding tax at source on royalties is limited to 10 percent (Article 12) rather than the zero rate in the U.S. model. The present treaty does not generally limit source country taxation of royalties, but does exempt certain copyright royalties (not film and video royalties) from tax at source. The current Australian statutory withholding rate on royalty payments (which would be reduced to 10 percent by the proposed treaty) is 51 percent in many cases.

(10) The proposed treaty allows source country taxation of capital gains generally including gain on disposition of real estate (thus preserving U.S. tax under the Foreign Investment in U.S. Real Property Tax Act of 1980 ("FIRPTA")). The U.S. model generally permits source country taxation of real estate gain and gain from the alienation of personal property attributable to a permanent establishment or fixed base in the source country but prohibits other source country taxation of capital gains.

(11) The proposed treaty allows source country taxation of independent personal services on the basis of presence in that country for more than 183 days in a taxable year. The model treaty does not allow taxation on that basis. Under the model, independent personal services of a nonresident are taxable only if the nonresident has available a fixed base in the source country.

(12) The proposed treaty allows source country taxation of entertainers and athletes who earn more than $10,000 there during a taxable year; the comparable amount in the model treaty is $20,000.

(13) The present treaty exempts from source country taxation the salaries of teachers from the other country who visit for two years or less. The proposed treaty, like the U.S. model, subjects those amounts to its standard rules, which would ordinarily result in full source country taxation.

(14) The proposed treaty exempts alimony payments from taxation in the country of the recipient's residence, while allowing the payor's country to tax them. The model treaty exempts such pay-

ments from taxation in the country of the payor's residence, while allowing the country of the recipient's residence to tax them.

(15) The proposed treaty's nondiscrimination provision is more limited than the U.S. model and provisions found in many U.S. tax treaties because it does not apply to the tax rules that were in effect in either country on the date of signature, August 6, 1982, and because it does not prevent discrimination by States and localities in their tax laws. The present treaty, however, does not limit discrimination at all.

(16) The proposed treaty provides for the exchange of information relating only to taxes it covers. The U.S. model treaty applies to taxes of every kind imposed by the contracting countries.

(17) The proposed treaty provides that any source country exemption of personal services income is inapplicable if the residence country exempts that income. The model treaty contains a similar provision that is not limited to personal services income. One effect of this provision is that a limited category of U.S. individuals who are exempt from U.S. tax on foreign earned income (under Code sec. 911) would be subject to Australian tax on Australian income.

## Issues

The proposed treaty presents the following specific issues:

(1) The nondiscrimination provision of the proposed treaty would permit discrimination under existing tax laws but not future laws. The United States model and most U.S. tax treaties contain a broad nondiscrimination provision that would prohibit the treaty partner from discriminating against U.S. investors. At the insistence of Australia, the nondiscrimination provision in the proposed treaty is not so comprehensive as that sought by the United States or as that contained in the U.S. or the OECD model treaties.

It could be argued that it is inappropriate to enter into a treaty with a developed country that permits even limited forms of discrimination. However, this article follows the U.S. position for the future, and is the broadest agreed to by Australia. (Australia has reserved its position on the OECD model Article.) Also, it is an improvement over the existing treaty which contains no nondiscrimination provision.

A secondary issue is whether, if discrimination is permitted, the United States should allow a foreign tax credit for the discriminatory taxes.

(2) The proposed treaty contains a permanent establishment article that in a number of cases is broader than that contained in the U.S. or OECD models. This would permit the country in which the activities are carried on to tax activities sooner than it would be able to under the model. Under the proposed treaty, the use of a drilling rig in a country for 6 months in any 24-month period creates a permanent establishment. Under the U.S. model, rigs must be present for at least one year. Under the proposed treaty, certain construction activities will create a permanent establishment if they exist in a country for nine months in contrast with the 12-month period in the U.S. model. Likewise, the performance of certain supervisory services can create a permanent establishment. The practical effect of the provision could be to increase Australian taxation of mineral exploration activities, construction activities,

and supervisory activities. These expansions were made at the insistence of Australia.

On the one hand, it might be argued that the United States should not make developing country concessions to a developed country. On the other hand, they recognize Australian status as a capital importing country, and also must be viewed in the context of an overall agreement that benefits a broad range of U.S. taxpayers and the United States.

(3) The proposed treaty would permit Australia to tax container leasing rentals and income from bare boat leases of ships or aircraft as royalties subject to a tax of 10 percent of gross in certain cases unless the lease is merely incidental to the operation in international traffic of ships or aircraft by the lessor. Under the U.S. model, this income is exempt from tax at source even though the lessor is not engaged in international traffic of ships or aircraft. The gross withholding tax permitted by the proposed treaty could exceed net income from leasing in certain cases. Shipping companies who lease containers as an incidental part of their business would not be subject to the tax, while competing container leasing companies that do not engage in shipping would be subject to the tax. Accordingly, such companies would have a competitive advantage over pure leasing companies.

While this provision is less favorable to container leasing companies than the model provision, it must be viewed in the context of the overall treaty. Also, container-leasing companies may receive more protection under the proposed treaty than under the existing treaty.

(4) The proposed treaty resembles in a few respects a treaty between a developed country and a developing country. In these respects, it does not conform to the U.S. model treaty. It provides for relatively high rates of source country withholding taxes and it provides permanent establishment rules that permit taxation of enterprises in cases where the U.S. model treaty would not. In addition, its nondiscrimination provision does not apply to existing rules. Although Australia is not so industrialized as the United States, it is a developed country. Australia is, however, a capital importer. Also, on balance, it can be argued that the proposed treaty is the product of a hard bargaining over a period of 14 years and is better for U.S. interests than the existing treaty.

## II. OVERVIEW OF UNITED STATES TAXATION OF INTERNATIONAL TRADE AND INVESTMENT AND TAX TREATIES

### A. United States Tax Rules

The United States taxes U.S. citizens and residents and U.S. corporations on their worldwide income. The United States taxes nonresident alien individuals and foreign corporations on their U.S. source income which is not effectively connected with the conduct of a trade or business in the United States (sometimes referred to as "noneffectively connected income"). They are also taxed on their U.S. source income and certain limited classes of foreign source income which is effectively connected with the conduct of a trade or business in the United States (sometimes referred to as "effectively connected income.")

Income of a nonresident alien or foreign corporation which is effectively connected with the conduct of a trade or business in the United States is subject to tax at the normal graduated rates on the basis of net taxable income. Deductions are allowed in computing effectively connected taxable income, but only if and to the extent they are connected with income which is effectively connected.

United States source fixed or determinable annual or periodical income (e.g., interest, dividends, rents, salaries, wages, premiums, annuities) which is not effectively connected income and which is received by a nonresident alien or foreign corporation is subject to tax at a rate of 30 percent of the gross amount paid. This gross tax on fixed or determinable income is often reduced or eliminated in the case of payments to residents of countries with which the United States has an income tax treaty.

The 30-percent (or lower treaty rate) tax imposed on U.S. source noneffectively connected income paid to foreign persons is collected by means of withholding (hence these taxes are often called withholding taxes).

Certain exemptions from the gross tax are provided. Bank account interest is defined as foreign source interest and, therefore, is exempt. Exemptions are also provided for certain original issue discount and for income of a foreign government from investments in U.S. securities. U.S. treaties also provide for exemption from tax in certain cases.

U.S. source noneffectively connected capital gains of nonresident individuals and foreign corporations are generally exempt from U.S. tax, with two exceptions: (1) gains realized by a nonresident alien who is present in the United States for at least 183 days during the taxable year, and (2) certain gains from the sale of U.S. real estate, discussed below.

Prior to June 18, 1980, noneffectively connected capital gains from the sale of U.S. real estate were subject to U.S. taxation only

if received by a nonresident alien who was present in the United States for at least 183 days. However, in the Omnibus Reconciliation Act of 1980 a provision was added to the Internal Revenue Code that the sale, exchange, or disposition of U.S. real estate by a foreign corporation or a nonresident alien would be taxed as effectively connected income. Also taxable under the legislation are dispositions by foreign investors of their interests in certain U.S. corporations and other entities whose assets include U.S. real property and associated personal property.

The source of income received by nonresident aliens and foreign corporations is determined under special rules contained in the Internal Revenue Code. Under these rules interest and dividends paid by a U.S. citizen or resident or by a U.S. corporation are considered U.S. source income. However, if a U.S. corporation derives more than 80 percent of its gross income from foreign sources, then dividends and interest paid by that corporation will be foreign source rather than U.S. source. Conversely, dividends and interest paid by a foreign corporation, at least 50 percent of the income of which is effectively connected income, are U.S. source to the extent of the ratio of its effectively connected income to total income.

Rents and royalties paid for the use of property in the United States are considered U.S. source income. The property used can be either tangible property or intangible property (e.g., patents, secret processes and formulas, franchises and other like property).

Since the United States taxes U.S. persons on their worldwide income, double taxation of income can arise because income earned abroad by a U.S. person may be taxed by the country in which the income is earned and also by the United States. The United States seeks to mitigate this double taxation by generally allowing U.S. persons to credit their foreign income taxes against the U.S. tax imposed on their foreign source income. A fundamental premise of the foreign tax credit is that it may not offset the U.S. tax on U.S. source income. Therefore, the foreign tax credit provisions contain a limitation that ensures that the foreign tax credit offsets only the U.S. tax on foreign source income. This limitation is computed on a worldwide consolidated basis. Hence, all income taxes paid to all foreign countries are combined to offset U.S. taxes on all foreign income.

A U.S. corporation that owns 10 percent or more of the voting stock of a foreign corporation may credit foreign income taxes paid or deemed paid by that corporation on earnings that are received as dividends. These deemed paid taxes are included in total foreign taxes paid for the year the dividend is received and go into the general pool of taxes to be credited.

Separate limitations on the foreign tax credit are provided for certain interest and for DISC dividends; also, special rules are provided for taxes imposed on oil extraction income.

### B. United States Tax Treaties—In General

The traditional objectives of U.S. tax treaties have been the avoidance of international double taxation and the prevention of tax avoidance and evasion. To a large extent, the treaty provisions designed to carry out these objectives supplement Code provisions

having the same objectives; the treaty provisions modify the generally applicable statutory rules with provisions which take into account the particular tax system of the treaty country. Given the diversity of tax systems in the world, it would be virtually impossible to develop in the Code rules which uniterally would achieve these objectives for all countries.

Notwithstanding the unilateral relief measures of the United States and our treaty partners, double taxation might arise because of differences in source rules between the United States and the other country. Likewise, if both countries consider the same deduction allocable to foreign sources, double taxation can result. Problems sometimes arise in the determination of whether a foreign tax qualifies for the U.S. foreign tax credit. Also, double taxation may arise in those limited situations where a corporation or individual may be treated as a resident of both countries and be taxed on a worldwide basis by both.

In addition, there may be significant problems involving "excess" taxation—situations where either country taxes income received by nonresidents at rates which exceed the rates imposed on residents. This is most likely to occur in the case of income taxed at a flat rate on a gross income basis. (Most countries, like the United States, generally tax domestic source income on a gross income basis when it is received by nonresidents who are not engaged in business in the country.) In many situations the gross income tax exceeds the tax which would have been paid under the net income tax system applicable to residents.

Another related objective of U.S. tax treaties is the removal of barriers to trade, capital flows, and commercial travel caused by overlapping tax jurisdictions and the burdens of complying with the tax laws of a jurisdiction when a person's contacts with, and income derived from, that jurisdiction are minimal.

The objective of limiting double taxation is generally accomplished in treaties by the agreement of each country to limit, in certain specified situations, its right to tax income earned from its territory by residents of the other country. For the most part, the various rate reductions and exemptions by the source country provided in the treaties are premised on the assumption that the country of residence will tax the income in any event at levels comparable to those imposed by the source country on its residents. The treaties also provide for the elimination of double taxation by requiring the residence country to allow a credit for taxes that the source country retains the right to impose under the treaty. In some cases, the treaties may provide for exemption by the residence country of income taxed by the source country pursuant to the treaty.

Treaties first seek to eliminate double taxation by defining the term "resident" so that an individual or corporation generally will not be subject to tax as a resident by each of the two countries. Treaties also provide that neither country will tax business income derived by residents of the other country unless the business activities in the taxing jurisdiction are substantial enough to constitute a branch or other permanent establishment or fixed base. The treaties contain commercial visitation exemptions under which individual residents of one country performing personal services in the

other will not be required to pay tax in that other country unless their contacts exceed certain specified minimums, for example, presence for a set number of days or earnings of over a certain amount.

Treaties deal with passive income such as dividends, interest, or royalties, or capital gains, from sources within one country derived by residents of the other country by either providing that they are taxed only in the country of residence or by providing that the source country's withholding tax generally imposed on those payments is reduced. As described above, the U.S. generally imposes a 30 percent tax and seeks to reduce this tax (on some income to zero) in its tax treaties, in return for reciprocal treatment by our treaty partner.

In its treaties, the United States, as a matter of policy, retains the right to tax its citizens and residents on their worldwide income as if the treaty had not come into effect, and provides this in the treaties in the so-called "saving clause". Double taxation can therefore still arise. Double taxation can also still arise because most countries will not exempt passive income from tax at the source.

This double taxation is further mitigated either by granting a credit for income taxes paid to the other country, or, in the case of some of our treaty partners, by providing that income will be exempt from tax in the country of residence. The United States provides in its treaties that it will allow a credit against U.S. tax for income taxes paid to the treaty partners, subject to the limitations of U.S. law. An important function of a treaty is to define the taxes to which it applies and to provide that they will be considered creditable income taxes for purposes of the treaty.

The treaties also provide for administrative cooperation between the countries. This cooperation includes a competent authority mechanism to resolve double taxation problems arising in individual cases, or more generally, by consultation between tax officials of the two governments.

Administrative cooperation also includes provision for an exchange of tax-related information to help the United States and its treaty partners administer their tax laws. The treaties generally provide for the exchange of information between the tax authorities of the two countries when such information is necessary for carrying out the provisions of the treaty or of their domestic tax laws. The obligation to exchange information under the treaties typically does not require either country to carry out measures contrary to its laws or administrative practices or to supply information not obtainable under its laws or in the normal course of its administration, or to supply information which would disclose trade secrets or other information the disclosure of which would be contrary to public policy.

The provisions generally result in an exchange of routine information, such as the names of U.S. residents receiving investment income. The IRS (and the treaty partner's tax authorities) also can request specific tax information from a treaty partner. This can include information to be used in a criminal investigation or prosecution.

The treaties generally provide that neither country may subject nationals of the other country (or permanent establishments of enterprises of the other country) to taxation more burdensome than that it imposes on its own nationals (or on its own enterprises). Similarly, in general, neither country may discriminate against its enterprises owned by residents of the other country.

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## III. EXPLANATION OF PROPOSED TAX TREATY

### Article 1. Personal Scope

The personal scope article describes the persons who may claim the benefits of the treaty and contains other rules including the "saving clause."

The proposed treaty applies generally to residents of the United States and to residents of Australia, with specific exceptions designated in other articles. This follows other U.S. income tax treaties, the U.S. model income tax treaty, and the OECD model income tax treaty. The terms "resident of the United States" and "resident of Australia" are defined in Article 4.

The proposed treaty provides that it does not restrict any benefits accorded by internal law or by any other agreement between the United States and Australia. Thus, the treaty will apply only where it benefits taxpayers.

Like all U.S. income tax treaties, the proposed treaty also contains a "saving clause." Under this clause, with specific exceptions described below, the treaty is not to affect the taxation by either country of its citizens or its residents. The proposed treaty would not affect the taxation of individuals electing under its domestic law to be taxed as residents of that taxing country. Under U.S. law, nonresident aliens may elect to be taxed as residents in certain circumstances (see sec. 6013(g), allowing filing of joint returns in certain cases upon such an election). By reason of the saving clause, unless otherwise specifically provided in the proposed treaty, the United States will continue to tax its citizens who are residents of Australia. Residents for purposes of the treaty (and thus, for purposes of the saving clause) include corporations and other entities as well as individuals (Article 4 (Residence)).

Under Section 877 of the Internal Revenue Code of 1954 ("Code"), a former U.S. citizen whose loss of citizenship had as one of its principal purposes the avoidance of U.S. income, estate or gift taxes, will, in certain cases, be subject to tax for a period of 10 years following the loss of citizenship. The treaty contains the standard provision found in the U.S. model and most recent treaties specifically retaining the right to tax former citizens. Even absent a specific provision the Internal Revenue Service takes the position that the United States retains the right to tax former citizens resident in the treaty partner (Rev. Rul. 79-152, 1979-1 C.B. 237).

Exceptions to the saving clause are provided for certain benefits conferred by the articles dealing with Associated Enterprises (Article 9); Pensions, Annuities, Alimony and Child Support (Article 18); Relief from Double Taxation (Article 22); Nondiscrimination (Article 23); Mutual Agreement Procedure (Article 24); and certain sourcing rules (Article 27).

In addition, the saving clause does not apply to the benefits conferred by one of the countries under the articles dealing with Governmental Remuneration (Article 19), Students (Article 20), or Diplomatic and Consular Privileges (Article 26), upon individuals (1) who are not citizens of that conferring country and (2) who in the case of the United States do not have immigrant status, or who in the case of Australia are not ordinarily resident in Australia.

**Article 2. Taxes Covered**

The proposed treaty generally applies to the income taxes of the United States and Australia.

In the case of the United States, the proposed treaty applies to the Federal income taxes imposed by the Internal Revenue Code, but excluding the accumulated earnings tax and the personal holding company tax. In the case of Australia, the proposed treaty applies to the Australian income tax, including the additional tax upon the undistributed amount of the distributable income of a private company. Although the U.S. model treaty applies to the excise tax on private foundations and (in certain cases) to the excise tax on insurance premiums paid to foreign insurers, the proposed treaty does not apply to those taxes. Thus, the United States could continue to impose them on residents of Australia.

The proposed treaty contains a provision generally found in U.S. income tax treaties to the effect that it will apply to substantially similar taxes that either country may subsequently impose. The proposed treaty also obligates the competent authority of each country, at the end of each calendar year, to notify the competent authority of the other country of any substantial changes that have been made during that year in the laws of his country relating to the taxes to which the treaty applies or in the official interpretation of those laws or of the treaty. This rule is similar to the rule of the U.S. model.

**Article 3. General Definitions**

Certain of the standard definitions found in most U.S. income tax treaties are contained in the proposed treaty. The proposed treaty deviates from the U.S. model in its definitions of U.S. corporation and Australian corporation.

The term "person" is defined to include an individual, an estate or trust, a partnership, a company and any other body of persons. A "company" is any body corporate or any entity which is treated as a company or body corporate for tax purposes. An enterprise of a country is defined as an enterprise carried on by a resident of that country. Although the treaty does not define the term "enterprise" it would have the same meaning that it has in other U.S. tax treaties—the trade or business activities undertaken by an individual, partnership, corporation, or other entity.

The proposed treaty defines international traffic as any transport by a ship or aircraft, except where the transport is solely between places in one of the contracting countries. Accordingly, purely domestic transport in the United States or in Australia is excluded.

The U.S. competent authority is the Secretary of Treasury or his delegate. In fact, the U.S. competent authority function has been delegated to the Commissioner of the Internal Revenue Service,

who has redelegated the authority to the Associate Commissioner (Operations). The Assistant Commissioner (Examination) has been delegated the authority to administer programs for simultaneous, spontaneous, and industry-wide exchanges of information. The Director, Foreign Operations District (formerly called the Director of the Office of International Operations), has been delegated the authority to administer programs for routine and specific exchanges of information and mutual assistance in collection. The Australian competent authority is the Commissioner of Taxation or his authorized representative.

The term "Contracting State" means the United States or Australia, as the context requires. The term "State" means any country, and is not necessarily limited to the United States and Australia.

The term "United States corporation" is defined to mean a corporation that (1) under U.S. tax law, is a domestic corporation or an unincorporated entity treated (under section 7701) as a domestic corporation, and (2) is not, under Australian tax law, a resident of Australia. Similarly, the term "Australian corporation" means a company (as defined under the Australian tax law) that (1) is (under the Australian tax law) a resident of Australia, and (2) is not, under U.S. tax law, a U.S. corporation or an unincorporated entity treated (under section 7701) as a U.S. corporation. Under Australian law, a resident company is defined as a company which is incorporated in Australia, or which, not being incorporated in Australia, carries on business in Australia, and has either its central management and control in Australia, or its voting power controlled by shareholders who are residents of Australia.

The interaction of United States and Australian law can result in a corporation being a resident of both countries under local law. For example, a corporation incorporated in the United States but carrying on business and being managed in Australia would be considered a domestic corporation by both countries under their local laws. The treaty provides that such a dual resident corporation is neither a U.S. nor an Australian corporation and thus would not be entitled to the benefits due a "United States corporation" or an "Australian corporation" under the treaty. The proposed treaty may tend to encourage corporations to arrange their affairs so as to obtain certain treaty benefits by being a resident of only one country. In this definition of residence, the proposed treaty differs from the U.S. model treaty, which seeks to find a single residence for corporations for treaty purposes.

The proposed treaty defines the terms "United States tax" and "Australian tax" as meaning the taxes covered by the treaty, but not penalties or interest imposed under the tax law of either country. Thus, the right of a country to impose penalties or interest is not limited by the proposed treaty.

The "United States" means the United States of America, a term that does not include Puerto Rico, the Virgin Islands, Guam or any other United States possession or territory. The definition of the United States also includes, when the term is used in a geographical sense, the territorial waters of the United States and the seabed and subsoil of the submarine areas adjacent to the coast of the United States but beyond the territorial waters of the United

States, which, in accordance with international law and the laws of the United States, are areas within which the United States exercises rights to exploit or explore for natural resources. The intent of this rule is to cover the U.S. continental shelf consistent with the definition of continental shelf contained in section 638 of the Code. In accordance with that intent, it is immaterial that no exploitation or exploration had occurred or was occurring in any particular area at the time of the signing of the treaty.

Under the proposed treaty, the term "Australia" means the Commonwealth of Australia. The definition of Australia also includes, when the term is used in a geographical sense, the Territory of Norfolk Island, the Territory of Christmas Island, the Territory of Cocos (Keeling) Island, the Territory of Ashmore and Cartier Islands, the Coral Sea Islands Territory, and any area adjacent to the territorial limits of Australia or any of those named territories which, in accordance with international law, is an area in which there is for the time being in force a law of Australia or of one of its States or Territories dealing with the exploitation of any of the natural resources of the sea-bed and subsoil of the continental shelf. Therefore, income earned on the Australian continental shelf is covered. The terms "resident of one of the Contracting States" and "resident of the other Contracting State" mean a resident of Australia or a resident of the United States, as the context requires.

The proposed treaty also contains the standard provision that, unless the context otherwise requires or the competent authorities of the two countries establish a common meaning, all terms are to have the meaning which they have under the applicable tax laws of the country applying the treaty.

**Article 4. Residence**

The assignment of a country of residence is important because the benefits of the proposed treaty generally are available only to a resident of one of the countries as that term is defined in the treaty. Furthermore, double taxation is often avoided by the treaty assigning one of the countries as the country of residence where under the laws of the countries the person is a resident of both.

Under U.S. law, residence of an individual is important because a resident alien is taxed on his worldwide income, while a nonresident alien is taxed only on U.S. source income and on his income that is effectively connected with a U.S. trade or business. The Code, however, does not define the term "residence." Instead, IRS regulations state that an alien is a resident of the United States if he is actually present in the United States and is not a mere transient or sojourner. Whether he is a transient is determined by his intentions as to the length and nature of his stay. (See Treas. Reg. sec. 1.871-2(b).) A company is resident in the United States if it is organized in the United States.

The proposed treaty defines "resident of Australia" to include any Australian corporation (as defined in Article 3 so as to exclude corporations with dual residence). The definition also includes any other person (other than a company, as defined in the Australian tax law) who is a resident of Australia under Australian tax law. However, two categories of persons are treated as residents of Aus-

tralia only to a limited extent (described below). These two categories of persons are (1) persons who are subject to Australian tax only on Australian source income (including certain residents of Australian territories), and (2) partnerships, estates, and trusts (other than certain charitable and employee-benefit trusts). Persons in these two categories are treated as Australian residents only (1) to the extent that the income they derive is subject to Australian tax as the income of an Australian resident, whether in the hands of one of the specified persons or in the hands of a partner in or beneficiary of such a person and, (2) to the extent that their income is exempt from Australian tax solely because it is subject to U.S. tax.

The proposed treaty defines "resident of the United States" to include any United States corporation (as defined in Article 3 so as to exclude corporations with dual residence). The term "resident of the United States" would generally include unincorporated entities treated as U.S. corporations for U.S. tax purposes. Corporations that are not U.S. corporations are not residents of the United States for purposes of the proposed treaty. In addition, the term "resident of the United States" includes any other person that is a U.S. resident for purposes of U.S. tax law. However, a partnership, estate, or trust will be considered to be a U.S. resident only (1) to the extent that the income it derives is subject to U.S. tax, either in its hands or in the hands of its partners or beneficiaries, as the income of a U.S. resident and (2) to the extent that its income is exempt from U.S. tax for reasons other than nonresidency (e.g., as an exempt organization under section 501(c)(3) of the Code or as a qualifying pension trust under section 401(a)). For example, if the share of U.S. residents in the profits of a U.S. partnership is only one-half, Australia would have to reduce its withholding tax on only half of the Australian source income paid to the partnership.

This provision of the proposed treaty is generally based on the fiscal domicile article of the U.S. model and OECD model tax treaties and is similar to the provisions found in other U.S. tax treaties. Consistent with most U.S. income tax treaties, citizenship alone does not establish residence. As a result, U.S. citizens residing overseas are not entitled to the benefits of the treaty as U.S. residents. This result is contrary to U.S. treaty policy as expressed in the U.S. model. The U.S. position is achieved in very few treaties.

A set of "tie-breaking" rules is provided to determine residence in the case of an individual who, under the basic treaty definition, would be considered to be a resident of both countries. Such a dual resident individual will be deemed for all purposes of the treaty to be a resident of the country in which he maintains his permanent home. In determining an individual's permanent home, regard is to be given to the place where the individual dwells with his family. If this permanent home test is inconclusive (because the individual has a permanent home in both countries or in neither), the individual's residence is deemed to be the country in which he has an habitual abode. If this habitual abode test is in its turn inconclusive, the individual's residence is deemed to be the country with which his personal and economic relations are closer. In determining the country with which such relations are closer, regard is to be given

to the individual's citizenship (if he is a citizen of one of the countries). The competent authorities of the United States and Australia are specifically authorized to agree as to with which country an individual has closer personal and economic relations (Article 24 (Mutual Agreement Procedure)).

When the tie-breaking rules described above operate to deem an individual a resident of Australia or of the United States for any taxable year, that individual shall be deemed to be a resident of only that country for that year.

**Article 5. Permanent Establishment**

The proposed treaty contains a definition of the term "permanent establishment" which, with certain exceptions, follows the pattern of other recent U.S. income tax treaties, the U.S. model, and the OECD model.

The permanent establishment concept is one of the basic devices used in income tax treaties to limit the taxing jurisdiction of the host country and thus mitigate double taxation. Generally, an enterprise that is a resident of one country is not taxable by the other country on its business profits unless those profits are attributable to a permanent establishment of the resident in the other country. In addition, the reduced rates of, or certain exemptions from, tax provided for dividends, interest, and royalties will apply unless the asset generating the income is effectively connected with the permanent establishment, in which case such items of income are taxed as business profits. U.S. taxation of business profits is discussed under Article 7 (Business Profits).

In general, under the proposed treaty, a permanent establishment is a fixed place of business through which an enterprise engages in business in the other country. A permanent establishment includes a place of management, a branch, an office, a factory, a workshop, a mine, an oil or gas well, a quarry, or other place of extraction of natural resources, and an agricultural, pastoral, or forestry property. It also includes any building site or construction, assembly or installation project, if the site or project lasts for more than 9 months. This 9-month period differs from the 12-month period of the U.S. model treaty. If the site or project lasts for 9 months or less, it does not constitute a permanent establishment. The use of an installation, drilling rig or ship in a country to dredge or for or in connection with exploration for or exploitation of natural resources of the sea-bed and subsoil also gives rise to a permanent establishment if the use in that country is for at least 6 months in any 24 month period. This 6-of-24 months rule differs from the 12-month rule of the U.S. model treaty. If use of an installation, rig or ship does not last as much as 6 months in any 24-month period, that use does not give rise to a permanent establishment. The current treaty does not contain special rules for building sites, etc.

This general rule is modified to provide that a fixed place of business that is used solely for any or all of a number of specified activities will not constitute a permanent establishment. These activities include the use of facilities for storing, displaying, or delivering merchandise belonging to the enterprise or for the maintenance of a stock of goods belonging to the enterprise for storage, display, or

delivery, or for processing by another enterprise. These activities also include the maintenance of a fixed place of business for the purchase of goods or merchandise, for the collection of information, for advertising or scientific research, or for any other preparatory or auxiliary activities for the enterprise.

If an enterprise of one country does business in the other country through a person who has, and habitually exercises, the authority to enter into contracts in that other country in the name of the enterprise, then the enterprise will be deemed to have a permanent establishment in the other country. This rule does not apply where the activities of the agent are limited to those activities (described above) such as storage, display, or delivery of merchandise which are excluded from the definition of permanent establishment. The proposed treaty contains the usual provision that the agency rule will not apply if the agent is a broker, general commission agent, or other agent of independent status acting in the ordinary course of its business.

In addition, an enterprise of one country will be deemed to have a permanent establishment in the other country if it maintains in that other country substantial equipment for rental or other purposes for a period exceeding 12 months. This rule does not apply to equipment leased under a hire-purchase agreement. The treaty does not define the term "substantial equipment."

An enterprise of one country will also be deemed to have a permanent establishment in the other country if it engages in supervisory activities in that other country for more than 9 months in any 24-month period in connection with a building site or construction, assembly or installation project in that other country. This 9-of-24-months rule for such supervisory activities activities contrasts with the 9-months-of-existence rule, described above, for the maintenance of such a site or project. There is no special rule for such supervisory activities in the U.S. model treaty.

In certain cases described below, an enterprise of one country will also be deemed to have a permanent establishment in the other country if it owns goods or merchandise that a second enterprise subjects to substantial processing in that other country after the first enterprise either (1) bought them in that other country (if the goods or merchandise were not subjected to prior substantial processing outside that other country), or (2) produced them in that other country (or if the goods were produced for the enterprise in question in that other country). This rule applies only in cases where either the first or the second enterprise participates directly or indirectly in the management, control, or capital of the other, or where the same persons participate directly or indirectly in the management, control, or capital of both enterprises. This rule is not in the U.S. model treaty or the OECD model. As compared to the models, it creates a broader concept of permanent establishment and thus a broader taxing jurisdiction of the country in which certain goods or merchandise were purchased or produced. This rule supplements the power of the competent authorities to include profits of one associated enterprise in the income of another on an arm's-length basis (Article 9).

The determination whether a company of one country has a permanent establishment in the other country is to be made without

regard to the fact that the company may be related to a resident of the other country or to a person who engages in business in that other country. The relationship is thus not relevant; only the activities of the company being tested are relevant.

The provisions described above are to be applied to determine, for purposes of the treaty, whether an enterprise of a country other than Australia or the United States has a permanent establishment in Australia or the United States, and whether an Australian or U.S. enterprise has a permanent establishment in a third country.

**Article 6. Income from Real Property**

This article covers income from owning real property. The rules governing income from the sale of real property are in Article 13.

Under the proposed treaty, income from real property may be taxed in the country where the real property is located. For purposes of the treaty, real property in a country will include leasehold interests in land (whether or not improved) located in that country. In addition, real property in a country will include rights to exploit or to explore for natural resources situated or sought in that country. Thus, income from real property will include royalties and other payments in respect of the exploitation of natural resources (e.g., oil). It does not include interest on loans secured by real property.

Certain U.S. treaties and the current U.S. model treaty permit residents of one country to elect to be taxed on income from real property in the other country on a net basis. The proposed treaty does not contain that election, but such an election is provided for United States real property income under the Code (secs. 871(d) and 882(d)), and Australia taxes income from real property on a net basis. Also, certain treaties limit the tax a country may impose on rental or royalty income from real property. There is no limit in the proposed treaty.

Under Article 13 (Alienation of Property), gains on the sale, exchange or other disposition of real property (and shares of certain corporations owning real property) may also be taxed by the country where the property is located.

**Article 7. Business Profits**

*U.S. Code rules.*—United States law distinguishes between the business income and the investment income of a nonresident alien or foreign corporation. A nonresident alien or foreign corporation is subject to a flat 30 percent (or lower treaty rate) rate of tax on certain U.S. source income if that income is not effectively connected with the conduct of a trade or business within the United States. The regular individual or corporate rates apply to income (from any source) which is effectively connected with the conduct of a trade or business within the United States.

The taxation of income as business or investment income varies depending upon whether the income is U.S. or foreign. In general, U.S. source periodic income (such as interest, dividends, rents and wages) and U.S. source capital gains, are effectively connected with the conduct of a trade or business within the United States only if the asset generating the income is used in or held for use in the

conduct of the trade or business, or if the activities of the trade or business were a material factor in the realization of the income. All other U.S. source income of a person engaged in a trade or business in the United States is treated as effectively connected income.

Foreign source income is effectively connected income only if the foreign person has an office or other fixed place of business in the United States and the income is attributable to that place of business. Only three types of foreign source income can be effectively connected income: rents and royalties derived from the active conduct of a licensing business; dividends, interest, or gain from stock or debt derived in the active conduct of a banking, financing or similar business in the United States; and certain sales income attributable to a United States sales office.

Except in the case of a dealer, trading in stocks, securities or commodities in the United States for one's own account does not constitute a trade or business in the United States and accordingly income from those activities is not taxed by the United States as business income. This concept includes trading through a U.S. based employee, a resident broker, commission agent, custodian or other agent or trading by a foreign person physically present in the United States.

***Proposed treaty rules.***—Under the proposed treaty, business profits of an enterprise of one country are taxable in the other country only to the extent they are attributable to a permanent establishment in the other country through which the enterprise carries on business. This is one of the basic limitations on a country's right to tax income of a resident of the other country.

The taxation of business profits under the proposed treaty differs from United States rules for taxing business profits primarily by requiring more than merely being engaged in trade or business before a country can tax business profits and by substituting the "attributable to" standard for the Code's "effectively connected" standard. Under the Internal Revenue Code, all that is necessary for effectively connected business profits to be taxed is that a trade or business be carried on in the United States. Under the proposed treaty, on the other hand, some level of fixed place of business must be present and the business profits must be attributable to that fixed place of business.

The business profits of a permanent establishment are determined on an arm's-length basis. Thus, there is to be attributed to a permanent establishment the business profits which would reasonably be expected to have been derived by it if it were a distinct and independent entity engaged in the same or similar activities under the same or similar conditions and dealing at arm's-length with the enterprise of which it is a permanent establishment, or with any other enterprise with which it deals. Thus, for example, this arm's-length rule applies to transactions between the permanent establishment and a branch of the resident enterprise located in a third country. Amounts may be attributed whether they are from sources within or without the country in which the permanent establishment is located.

In computing taxable business profits, deductions are allowed for expenses, wherever incurred, which are reasonably connected with

those profits. These deductions include a reasonable allocation of executive and general administrative expenses and other expenses. Thus, for example, a U.S. company which has a branch office in Australia but which has its head office in the United States will, in computing the Australian tax liability of the branch, be entitled to deduct the executive, general administrative and other expenses incurred in the United States by the head office that are reasonably connected with the profits of the Australian branch. However, no expenses (wherever incurred) are to be deductible unless they would be deductible if the permanent establishment were an independent entity that paid them.

Unlike some U.S. treaties and the U.S. model, the proposed treaty does not define the term "business profits." Thus, to the extent not dealt with in other Articles, the term will be defined under the law of the two countries. If the definitions cause double taxation, the competent authorities could agree on a common meaning of the term.

Business profits will not be attributed to a permanent establishment merely by reason of the purchase of merchandise by a permanent establishment for the account of the enterprise. Thus, where a permanent establishment purchases goods for its head office, the business profits attributed to the permanent establishment with respect to its other activities will not be increased by a profit element in its purchasing activities.

The amount of profits attributable to a permanent establishment must be determined by the same method each year unless there is good and sufficient reason to change the method.

Where business profits include items of income which are dealt with separately in other articles of the treaty, those other articles, and not this Business Profits Article, will govern the treatment of those items of income. Thus, for example, film rentals are generally taxed under the provisions of Article 12 (Royalties), and not as business profits.

The proposed treaty contains a provision, not generally found in other treaties, that permits a country to determine the tax liability of a person under internal law where the information available to the competent authority of that country is inadequate to determine the profits attributable to a permanent establishment. However, on the basis of available information, the determination of the profits of the permanent establishment must be consistent with the principles of the Article.

The proposed treaty allows either country to continue to tax persons carrying on an insurance business under its internal law rather than under the treaty's business profits rules. This exception from treaty coverage continues so long as the law relating to insurance taxation in effect on the date of signature of the convention is not changed other than in minor respects that do not affect its general character.

**Article 8. Shipping and Air Transport**

As a general rule, the United States taxes the U.S. source income of a foreign person from the operation of ships or aircraft to or from the United States. An exemption from U.S. tax is provided if the ship or aircraft is documented under the laws of a for-

eign country that grants an equivalent exemption to U.S. citizens and corporations. The United States has entered into agreements with a number of countries under which that country grants an exemption which results in the United States exempting that country's shipping.

The proposed treaty provides that profits which are derived by a resident of one country from the operation of ships or aircraft in international traffic ("shipping profits") shall be exempt from tax by the other country. International traffic means any transportation by ship or aircraft, except where the transportation is solely between places in one of the countries (Article 3(1)(d) (General Definitions)). The proposed treaty also provides, in Article 8(3), that profits derived from the carriage by ships or aircraft of passengers, livestock, mail, goods or merchandise shipped in one country for discharge at another place in that country are not profits from international traffic and may be taxed in that country. This provision in Article 8(3) largely duplicates the effect of the definition of international traffic in Article 3(1)(d).

This exemption applies even if the ship or aircraft is not registered in either country. Thus, for example, income of a U.S. resident from the operation of a ship flying, for example, the Liberian flag would not be subject to Australian tax. This exemption based solely on residence is a liberalization of the rule in the present treaty that generally provides for an exemption only if the ship or aircraft is registered in the country of residence (or, in the case of the United States, corporate organization or citizenship) of the operator. The exemption also applies to income derived from the operation of ships and aircraft in international traffic through participation in a pool service, a joint transportation operating organization or an international operating agency.

Under the proposed treaty, certain profits from the rental of ships or aircraft would be exempt from tax in the country not the residence of the lessor as profits from the operation of ships and aircraft in international traffic. The rules governing the availability of the exemption differ according to whether the rental occurs on a full basis or a bare boat basis. (Rental on a full or bare boat basis refers to whether the ships or aircraft are leased fully equipped, manned and supplied or not.)

The proposed treaty exempts from tax (as shipping and aircraft income) a narrower category of leasing income than the U.S. model treaty exempts. Income from leasing ships or aircraft on a full basis is exempt under the proposed treaty if the ship or aircraft is operated by the lessee in international traffic and if the lessor either operates ships or aircraft otherwise than solely between places in the country not of his residence or regularly leases ships or aircraft on a full basis. Profits from the lease of ships or aircraft on a bare boat basis (or of containers and related equipment) for operation or use by the lessee in international traffic are shipping profits exempt under the treaty if the lease is merely incidental to the operation of ships and aircraft in international traffic by the lessor. Under the U.S. model treaty, income from leasing ships or aircraft (on a full or bare boat basis) is exempt if the lessee operates the ships or aircraft in international traffic or if the profits are incidental to other shipping or transport profits. The U.S.

model treaty generally does not condition the exemption of container leasing income on any other activity of the lessor.

**Article 9. Associated Enterprises**

The proposed treaty, like most other U.S. tax treaties, contains an arm's-length pricing provision similar to section 482 of the Internal Revenue Code, which recognizes the right of each country to make an allocation of income to that country in the case of transactions between related enterprises, if an allocation is necessary to reflect the conditions and arrangements which would have been made between independent enterprises.

For purposes of the proposed treaty an enterprise of one country is related to an enterprise of the other country if one of the enterprises participates directly or indirectly in the management, control or capital of the other enterprise. The enterprises are also related if the same persons participate directly or indirectly in the management, control, or capital of both enterprises.

When a redetermination of tax liability has been properly made by one country, the other country will make an appropriate adjustment to the amount of tax paid in that country on the redetermined income. In making that adjustment due regard is to be given to other provisions of the treaty and the competent authorities of the two countries will consult with each other if necessary. To avoid double taxation, the proposed treaty's saving clause retaining full taxing jurisdiction in the country of residence or citizenship will not apply in the case of such adjustments.

These provisions of the proposed treaty are not intended to affect the application of any law in either country that relates to the determination of the tax liability of a person. This provision makes clear that the U.S. retains the right to apply its intercompany pricing rules (section 482) and its rules relating to the allocation of deductions (sections 861, 862, and 863, and Treas. Reg. Section 1.861-8). Moreover, these provisions are not to supersede U.S. or Australian law relating to determinations in cases where the information available to the competent authority is inadequate to determine the income to be attributed to an enterprise, so long as the competent authority proceeds on the basis of available information consistently with these rules. Thus, the treaty does not affect the U.S. rule that the burden of proof is on the taxpayer.

**Article 10. Dividends**

The United States imposes a 30-percent tax on the gross amount of U.S. source dividends paid to nonresident alien individuals and foreign corporations. The 30-percent tax does not apply if the foreign recipient is engaged in a trade or business in the United States and the dividends are effectively connected with that trade or business. In such a case, the foreign recipient is subject to U.S. tax like a U.S. person at the standard graduated rates on a net basis. U.S. source dividends are dividends paid by a U.S. corporation, and certain dividends paid by a foreign corporation if at least 50 percent of the gross income of the foreign corporation, in the prior three year period, was effectively connected with a U.S. trade or business of that foreign corporation.

Under the proposed treaty, dividends paid by a company that is a resident of one country, and to which a resident of the other country is beneficially entitled, may be taxed by both countries. However, the rate of tax that the country of which the payor is a resident may impose is limited to 15 percent of the gross amount of the dividends. This 15-percent rate is the rate found in the existing treaty with Australia. The current statutory rate in Australia is 30 percent. The proposed treaty's 15 percent rate is greater than the five-percent rate found in many U.S. treaties and the U.S. model with respect to dividends on direct investment, but Australia has not to date agreed to any treaty providing a lower rate.

The proposed treaty defines dividends as income from shares. Dividends also include income from other corporate rights which are taxed by the country in which the distributing corporation is resident in the same manner as income from shares. Under this provision, each country may apply its rules for determining when a payment by a resident company is on a debt obligation or an equity interest. Thus, for example, the United States could apply its section 385 rules for determining whether an interest is debt or equity.

The reduced rates of tax on dividends will apply unless the recipient has a permanent establishment (or fixed base in the case of an individual performing independent personal services) in the source country and the shareholdings on which the dividends are paid are effectively connected with the permanent establishment (or fixed base). Dividends effectively connected with a permanent establishment are to be taxed on a net basis as business profits (Article 7). Dividends effectively connected with a fixed base are to be taxed on a net basis as income from the performance of independent personal services (Article 14).

One country may not tax dividends paid by a company resident in the other country except in three cases: first, where a resident of the first country is beneficially entitled to the dividends; second, where the shares in respect of which the dividends are paid are effectively connected with a permanent establishment or a fixed base of the beneficial owner of the dividends in the taxing country; and third, where at least 50 percent of the paying company's gross income was attributable to one or more permanent establishments in the taxing country. In this last situation, however, the tax can be imposed only to the extent the dividends are paid out of the profits attributable to those permanent establishments and only if the country does not impose a tax not covered by the treaty (other than the U.S. accumulated earnings tax or personal holding company tax) such as the branch profits tax described in the following paragraph. The United States does not now impose a branch profits tax or similar tax, while Australia does. Thus, the United States, but not Australia, would now be authorized to tax dividends under this third (50 percent of gross income) provision. Under this provision, the rate of tax on the taxable portion is limited to the 15-percent withholding rate applicable to dividends. This third provision enables the United States to continue to tax dividends paid by foreign corporations doing substantial business in the United States. The provision is, however, different from the U.S. rules because the proposed treaty's permanent establishment concept is more limited

than the U.S. trade or business concept. (See discussion in Article 7 (Business Profits).)

The proposed treaty also reserves the right of the United States or Australia to impose a tax (such as a branch profits tax) on a source basis in addition to the regular corporate tax imposed on a permanent establishment maintained there on the earnings of such a permanent establishment. A country could impose such a tax under the proposed treaty only if it did not impose a tax on dividends on the ground that at least 50 percent of the paying company's gross income was attributable to one or more permanent establishments in the taxing country. The rate of tax is limited to 15 percent of net earnings after the ordinary income tax. (With the current 46 percent tax rate effective in Australia, this limitation is equivalent to a rate of 8.1 percent of pre-tax earnings.) The purpose of this provision is to permit Australia, subject to the special limitations, to continue to impose its so-called branch profits tax. The Australian tax is currently imposed at the rate of 5 percent of certain pre-tax Australian source income of a nonresident of Australia, whether or not that nonresident is a branch of a foreign corporation. The United States does not impose such a tax. This tax, like the U.S. withholding tax on certain dividends of foreign corporations that are attributable to a U.S. trade or business, serves as a substitute, as to the branch operations of foreign corporations, for the withholding tax imposed on payments by domestic subsidiaries to their foreign parents.

Australia imposes an undistributed profits tax on the retained earnings of private companies, generally those not listed on stock exchanges and 75 percent of whose beneficial ownership (or whose parent company's beneficial ownership) is in the hands of a small number of persons. Under the proposed treaty, Australia would grant some relief to private U.S. companies with undistributed Australian profits. Australia, under the proposed treaty, would have to calculate this undistributed profits tax on private companies that are U.S. residents as if those companies were not liable for the branch profits tax discussed above and as if those companies had paid dividends in such amounts that the withholding tax due on those dividends would equal the branch profits tax. For example, a U.S. resident private company earning $100 of Australian income would be subject to a regular Australian corporate tax of $46 and a branch profits tax of $5. Calculating the undistributed profits tax as if no branch profits tax were due would result in $54 (rather than $49) being treated as after-tax income. The branch profits tax of $5 equals the 15 percent withholding tax if that latter tax were applied to the amount of $33.33. Therefore, the undistributed profits tax would apply to $20.67 ($54–$33.33).

The treaty would allow the United States to adopt the Australian type of branch profits tax, subject to the same rules that apply to Australia.

**Article 11. Interest**

The United States imposes a 30-percent tax on U.S. source interest paid to foreign persons under the same rules that are applicable to dividends. Under the Code, U.S. source interest generally is interest on debt obligations of U.S. persons, but not interest on de-

posits in banks. U.S. source interest also includes interest paid by a foreign corporation if a least 50 percent of the gross income of the foreign corporation, in the prior three year period, was effectively connected with a U.S. trade or business of that corporation.

Under the proposed treaty, interest may be taxed by a country if the beneficial owner of the interest is a resident of that country, the interest arose in that country, or the indebtedness to which the interest relates is effectively connected with a permanent establishment or fixed base of the beneficial owner of the interest in that country. The proposed treaty limits the withholding tax imposed by reason of source to 10 percent generally. The present treaty does not limit the withholding tax on interest, although the current Australian statutory rate of withholding tax is 10 percent. The U.S. model treaty provides for elimination of the withholding tax on portfolio interest (a zero rate), although this result is rarely achieved. The limitation in the proposed treaty applies only if the interest is beneficially owned by a resident of the other country; it does not apply if the recipient is a nominee for a nonresident.

The reduced tax rate will not apply if the recipient has a permanent establishment or fixed base in the source country and the debt claim is effectively connected with that permanent establishment or fixed base. In that event, the interest will be taxed as business profits (Article 7) or income from the performance of independent personal services (Article 14).

The proposed treaty addresses the issue of non-arm's-length interest charges between parties having a special relationship by providing that the amount of interest for purposes of the treaty will be the amount of arm's-length interest. The amount of interest in excess of the arm's-length interest will be taxable according to the laws of each country, taking into account the other provisions of this treaty (e.g., excess interest paid to a parent corporation may be treated as a dividend under local law and thus entitled to the benefits of Article 10 of this treaty).

The proposed treaty defines interest to include any income treated under the tax law of the source country as interest. Under this provision, each country may apply its rules for determining when a payment by a resident company is on a debt obligation or an equity interest. Thus, the United States could apply its section 385 rules for determining whether an interest is debt or equity.

The proposed treaty provides a source rule for interest (which is also used in Article 22 (Relief from Double Taxation) for foreign tax credit purposes). Interest will be sourced within a country if the payor is the government of that country, including political subdivisions and local authorities, or a resident of that country. Generally, this is consistent with U.S. source rules (sections 861-862) which provide that interest income is sourced in the country in which the payor is resident. However, if the interest is borne by a permanent establishment (or fixed base) that the payor has in a country other than his country of residence and the indebtedness was incurred with respect to that permanent establishment (or fixed base), interest will be sourced in that country, regardless of the residence of the payor. Thus, for example, if an Australian resident has a permanent establishment in France and that Australian resident incurs indebtedness to a U.S. person for that French per-

manent establishment, and the permanent establishment bears the interest, then the interest will, for purposes of the proposed treaty, have its source in France and Australia will not tax the interest.

Australian law now exempts from tax payments of interest to foreign governments and their agencies (including payments to the Export-Import Bank). The treaty does not guarantee that such exemption will continue.

**Article 12. Royalties**

Under the same system that applies to dividends and interest, the United States imposes a 30-percent tax on U.S. source royalties paid to foreign persons. Royalties are from U.S. sources if they are for the use of property located in the United States. U.S. source royalties include royalties for the use of or the right to use intangibles in the United States. Such royalties include motion picture royalties.

The present treaty with Australia does not generally limit source country taxation of royalties. The present treaty exempts from source country taxation, however, royalties from the use of copyrights of literary, dramatic, musical, or artistic works, but does not limit source country taxation of royalties for motion pictures, videotapes, and the like.

Australia subjects royalties paid by Australian residents to U.S. persons (that are not exempt under the present treaty) to withholding of 51 percent of the gross royalty. This withholding provision is an enforcement mechanism for the income tax on royalties, which Australia imposes at the rate of 51 percent of the net royalty. (The 51 percent rates represent the sum of the regular corporate tax rate, 46 percent, and the rate of an additional tax (the "branch profits tax"), 5 percent, imposed on certain income from Australian sources earned by foreign persons.) Absent proof that expenses are associated with the royalty income and thus that the gross royalty and the net royalty are different, the U.S. recipient of the royalty is generally subject under the present treaty to tax at the rate of 51 percent of the gross royalty. Such proof has sometimes been difficult for U.S. taxpayers to supply. When the U.S. taxpayer cannot supply adequate proof, it pays Australian tax at the rate of 51 percent of the gross royalty. A special Australian statutory rate of 10 percent of the gross royalty applies to royalties received by nonresidents of Australia for the right to use motion picture or television films, videotapes, or related copyrights or advertising materials, however.

The proposed treaty provides for a limitation of the rate of source basis taxation of royalties. Royalties from sources (under the royalty source rule discussed below) in one country that are beneficially owned by a resident of the other country may be taxed by both countries. However, the withholding tax imposed in the source country may not exceed 10 percent of the gross royalty. As noted above, the present treaty exempts from source country taxation only certain royalties, while allowing full source country taxation of most kinds of royalties (currently up to 51 percent of the gross amount in the case of Australia). Although the bulk of Australian source royalty income would be subject to a lower rate of withholding tax under the proposed treaty than under the present treaty,

certain copyright income that is exempt under the present treaty would be subject to taxation (at up to the 10-percent rate) under the proposed treaty. The 10-percent rate limitation in the proposed treaty applies only if the royalty is beneficially owned by a resident of the other country; it does not apply if the recipient is a nominee for a nonresident.

In certain cases, under the proposed treaty, income from leasing of ships, aircraft, and containers would be royalties subject to withholding tax at the source of up to 10 percent of gross receipts if the lessor had no permanent establishment in the source country (see Article 8 (Shipping and Air Transport)).

The U.S. model treaty exempts royalties from tax at source.

The reduced withholding tax rate does not apply where the beneficial owner has a permanent establishment in the source country or performs personal services in an independent capacity through a fixed base in the source country, and the property giving rise to the royalties is effectively connected with the permanent establishment or fixed base. In that event the royalties will be taxed as business profits (Article 7) or income from the performance of independent personal services (Article 14).

Royalties are defined as payments or credits for the use of, or the right to use, copyrights, patents, designs, models, plans, secret processes or formulae, trademarks or other similar property or rights. Royalties also include payments or credits for the use of, or the right to use, industrial, commercial, or scientific equipment (not leased under a hire-purchase agreement), motion picture films, films or video tapes for television use, and audio tapes for radio use. In addition, royalties include payments or credits for the supply of scientific, technical, industrial or commercial knowledge or information owned by any person, the supply of any ancillary and subsidiary assistance furnished to enable the application or enjoyment of such knowledge or of any other property or right to which this article applies, or any forbearance in respect of any such property or right. Thus, payments for the royalty-free use of a copyright or patent could be considered to involve a royalty. In addition, income from the disposition of any property or right described above constitutes royalty income to the extent that the amounts realized on the disposition are contingent on the productivity, use, or further disposition of such property or right.

The proposed treaty provides that in the case of royalty payments or credits between persons having a special relationship, only that portion of the payment or credit that represents an arm's-length royalty will be treated as a royalty under the treaty. Payments in excess of the arm's-length amount will be taxable according to the law of each country with due regard being given for the other provisions of the treaty. Thus, for example, any excess amount might be treated as a dividend subject to the taxing limitations of Article 10.

The proposed treaty provides special source rules for royalties. Generally, under U.S. tax rules (section 861-862) royalty income is sourced where the property or right is being used. The treaty alters this rule in certain cases. If a royalty is paid by the government of one of the countries, including political subdivisions and local authorities, or by a resident of one of the countries, then the income

will generally be sourced in the country of residence of the payor. However, if the payor has a permanent establishment or fixed base in a country in connection with which the obligation to pay the royalty was incurred, and if the royalties are borne by the permanent establishment or fixed base, the royalties arise (for purposes of the proposed treaty) in the country in which the permanent establishment or fixed base is situated. Finally, if the above rules do not result in a U.S. or Australian source for the royalties, and if the royalties relate to the use of or the right to use rights or property in either the United States or Australia, then the source of the royalties will be that country.

**Article 13. Alienation of Property**

Generally, gain realized by a nonresident alien or a foreign corporation from the sale of a capital asset is not subject to U.S. tax unless the gain is effectively connected with the conduct of a U.S. trade or business or, in the case of a nonresident alien, he is physically present in the United States for at least 183 days in the taxable year. However, under the Foreign Investment in Real Property Tax Act of 1980, as amended, a nonresident alien or foreign corporation is taxed by the United States on gain from the sale of a U.S. real property interest as if the gain were effectively connected with a trade or business conducted in the United States. A U.S. real property interest includes corporations holding U.S. real property.

Under the proposed treaty gains from the disposition of real property may be taxed in the country where the real property is situated. The treaty defines real property situated in the United States and real property situated in Australia separately. Real property situated in the United States includes real property located here for the purposes of Article 6. It also includes United States real property interests. This definition allows the United States to tax any transaction of an Australian resident taxable under the Foreign Investment in Real Property Tax Act of 1980.

Real property situated in Australia includes any property that is real property under Australian law, as that law changes from time to time. Without limiting the broad reach of the Australian law test, the proposed treaty specifically includes in the definition of real property situated in Australia three categories of property: real property located there for the purposes of Article 6; shares (or comparable interests) in a company whose assets are wholly or principally Australian real property; and an interest in a partnership, trust, or estate whose assets are wholly or principally Australian real property. Such shares and interests are deemed to be situated in Australia, wherever the entity was created or is operated, and wherever any shares or other evidences of ownership may be found. The treaty does not define the term "principally."

Gains from the sale or exchange of ships, aircraft or containers operated or used by an enterprise of one country in international traffic are taxable only by the country of residence. However, the other country (not the country of residence) may tax the gain to the extent that it allowed depreciation to that enterprise in respect of such items. Thus, that country may recapture that depreciation. Gains from dispositions of property or rights that are subject to tax

under the royalty article (Article 12) as contingent on productivity, use, or further disposition are taxable only under that article; that is, the source country tax is generally limited to 10 percent of the gross amount.

The U.S. model treaty generally allows the country that is not the country of residence to tax gains from dispositions of only enumerated property (such as real property located in that country or personal property attributable to a permanent establishment or fixed base in that country). Under the model treaty, gains from dispositions of other property are taxable only in the country of residence. The proposed treaty does not provide such a restriction. Therefore, gains from dispositions of property not mentioned in this article are subject to the general rule of Article 21 (Income Not Expressly Mentioned), which provides that income from sources within a country may be taxed in that country.

**Article 14. Independent Personal Services**

The United States taxes the income of a nonresident alien at the regular graduated rates if the income is effectively connected with the conduct of a trade or business in the United States by the individual. (See discussion of U.S. taxation of business profits under Article 7 (Business Profits).) The performance of personal services within the United States can be a trade or business within the United States (sec. 864(b)).

The proposed treaty limits the right of a country to tax income from the performance of personal services by a resident of the other country. Under the proposed treaty, income from the performance of independent personal services is treated separately from income from the performance of personal services as an employee.

Income from the performance of independent personal services (i.e., services performed as an independent contractor, not as an employee) in one country by a resident of the other country is exempt from tax in the country where the services are performed, unless (1) the person performing the personal services is present in the country where the services are performed for more than 183 days during the taxable year or (2) the individual has a fixed base regularly available to him in that country for the purpose of performing the services. In the second situation, the source country can tax only that portion of the individual's income which is attributable to the fixed base.

Independent personal services include all independent activities, not merely those of persons in professions such as physicians, lawyers, engineers, architects, dentists, and accountants.

The proposed treaty provides a broader exemption from tax than the present treaty. While the present treaty contains a 183-day rule, it does not exempt income under that rule unless the person performing the services does so for or on behalf of a resident of the country of which he is resident. However, the present treaty does not contain the fixed base rule of the proposed treaty; under the present treaty, a fixed base maintained in a country for the purpose of performing services does not necessarily cause taxation of those services in that country. The U.S. model treaty, by contrast, does not contain a 183-day rule, but rather allows taxation in the

source country only on the basis of a fixed base regularly available to the individual performing the independent services.

**Article 15. Dependent Personal Services**

Under the Code, the income of a nonresident alien from the performance of personal services in the United States is not taxed if the individual is not in the United States for at least 90 days during a taxable year, the compensation does not exceed $3,000, and the services are performed as an employee of a foreign person not engaged in a trade or business in the United States or they are performed for a foreign permanent establishment of a U.S. person.

Under the proposed treaty, income from services performed as an employee or as a director of a company in one country (the source country) by a resident of the other country will be taxable only in the country of residence if three requirements are met: (1) the individual is present in the source country for fewer than 184 days during the taxable year; (2) his employer or company is not a resident of the source country; and (3) the compensation is not deductible by a permanent establishment, fixed base or a trade or business of the employer in the source country.

Compensation derived by an employee aboard a ship or aircraft operated by a resident of one country in international traffic may be taxed by that country.

This article is modified in some respects for pensions (Article 18) and for compensation as a government employee (Article 19).

The present treaty does not distinguish between dependent and independent personal services. The present treaty rules are discussed in the discussion of Article 14, above. In addition, the present treaty contains a special rule for teachers that allows visits of up to two years duration without subjecting the visiting teacher to taxation in the country he visits. Under the proposed treaty, as in the U.S. model, teachers who perform dependent personal services will be subject to the general rules for employees.

**Article 16. Limitation On Benefits**

The proposed treaty contains a provision which is intended to limit the benefits of the treaty to persons who are entitled to those benefits by reason of their residence in the United States or Australia.

The proposed treaty is intended to limit double taxation caused by the interaction of the tax systems of the United States and Australia as they apply to residents of the two countries. At times, however, residents of third countries attempt to use a treaty. Such use is known as "treaty shopping", and refers to the situation where a person who is not a resident of either country seeks certain benefits under the income tax treaty between the two countries. Under certain circumstances, and without appropriate safeguards, the nonresident is able indirectly to secure these benefits by establishing a corporation (or other entity) in one of the countries which, as a resident of that country, is entitled to the benefits of the treaty. Additionally, it may be possible for the third country resident to repatriate funds to that third country from the entity under favorable conditions (i.e., it may be possible to reduce or eliminate taxes on the repatriation) either through relaxed tax pro-

visions in the distributing country or by passing the funds through other treaty countries (essentially, continuing to treaty shop), until the funds can be repatriated under favorable terms.

The proposed treaty contains provisions intended to limit the benefits of the treaty to bona fide residents of the two countries. This is accomplished by providing that a person other than an individual (such as a corporation, partnership or trust) is not entitled to the benefits of the convention unless it satifies any one of an ownership test, a public company test, or a good business purpose test. Under the ownership test, more than 75 percent of the beneficial interest (in the case of a company, more than 75 percent of the number of shares of each class of shares) in that entity must be owned directly or indirectly by any combination of one or more individual residents of Australia or the United States, citizens of the United States, publicly traded companies (discussed below), or the governments of the countries (the United States and Australia) themselves. This provision would, for example, deny the benefits of the reduced U.S. withholding tax rates on dividends, interest or royalties to an Australian company that is owned by individual residents of a third country.

Under the public company test, a company that is a resident of one of the countries and that has substantial and regular trading in its principal class of stock on a recognized stock exchange in the United States or Australia is entitled to the benefits of the treaty regardless of where its actual owners reside. In addition, any interest that such a company holds is a qualifying interest under the 75-percent test above. The term "recognized stock exchange" includes the NASDAQ System owned by the National Asociation of Securities Dealers, Inc. in the United States.

Under the good business purpose test, denial of treaty benefits does not occur if the acquisition, ownership and maintenance of an entity that is a resident of the United States or Australia and the conduct of its operations did not have as one of its principal purposes the purpose of obtaining benefits under the proposed treaty. Accordingly, the provision will not apply if it can be shown that there was no treaty shopping motive for forming the company and if its operation does not have as one of its principal purposes the purpose of obtaining the treaty benefits. Thus the burden of overcoming the treaty shopping rule, as under U.S. tax law generally, is on the taxpayer claiming treaty benefits.

The proposed treaty disallows treaty benefits to any income derived by a trustee that is treated as income of a resident of the United States or Australia for purposes of the treaty if the trustee derived that income in connection with a scheme one of whose principal purposes was to obtain a benefit under the treaty.

**Article 17. Entertainers**

The proposed treaty contains an additional set of rules which apply to the taxation of income earned by entertainers (such as theater, motion picture, radio or television entertainers, musicians, and athletes). The proposed article supplements the other provisions dealing with the taxation of income from personal services (Articles 14 and 15) and is intended, in part, to prevent entertain-

ers and athletes from using the treaty to avoid paying any tax on their income earned in one of the countries.

Under the Article, one country may tax an entertainer who is a resident of the other country on the income from his personal services as an entertainer in that country during any year in which the gross receipts derived by him from such activities, including his reimbursed expenses, exceed $10,000 or its equivalent in Australian dollars. (The comparable amount in the U.S. model treaty is $20,000.) Thus, if an Australian entertainer maintained no fixed base in the United States and performed (as an independent contractor) for two days in one taxable year in the United States for total compensation of $9,000, the United States could not tax that income. If, however, that entertainer's total compensation were $11,000, the full $11,000 (less appropriate deductions) would be subject to U.S. tax. As in the case of the other provisions dealing with personal services income, this provision does not bar the country of residence or, in the case of the United States, the country of citizenship, from also taxing that income (subject to a foreign tax credit).

In addition, the proposed treaty provides that where income in respect of personal services performed by an entertainer or athlete accrues not to the entertainer or athlete but rather to another person or entity, that income will be taxable by the country in which the services are performed in any situation where the entertainer or athlete shares directly or indirectly in the profits of the person or entity receiving the income. (This provision applies notwithstanding Articles 7, 14, and 15.) For this purpose, participation in the profits of the recipient of the income includes the receipt of deferred compensation, bonuses, fees, dividends, partnership distributions, or other distributions. The provision does not apply if it is established that neither the entertainer or athlete, nor related persons, participate directly or indirectly in the profits of the person or entity receiving the income in any manner. This provision is intended to prevent highly paid performers and athletes from avoiding tax in the country in which they perform by routing the compensation for their services through a third person such as a personal holding company or trust located in a country that would not tax the income.

**Article 18. Pensions, Annuities, Alimony and Child Support**

Under the proposed treaty, pensions and other similar remuneration paid to a resident of either country are subject to tax only in the recipient's country of residence. (This rule does not apply in the case of pensions which are paid to citizens of one country attributable to services performed by the individual for government entities of the other (Article 19 (Governmental Remuneration)).) The term "pensions and other similar remuneration" is defined to mean periodic payments made by reason of retirement or death, in consideration for services rendered, or as compensation paid after retirement in consideration of injuries received in connection with past employment. Social Security payments and other similar public pension payments paid by one country to a resident of the other country or to a U.S. citizen will be taxable only by the paying country. This rule, which is not overriden by the saving clause,

exempts U.S. citizens and residents from U.S. tax on Australian social security payments and Australian residents from Australian tax on U.S. social security payments.

The proposed treaty also provides that annuities may be taxed only by the recipients' country of residence. Annuities are defined as stated sums paid periodically at stated times during life or during a specified or ascertainable number of years, under an obligation to make the payments in return for adequate and full consideration (other than services).

Under the proposed treaty alimony and maintenance payments (including child support payments) are taxable in the source country, but are exempt from residence country taxation. The saving clause does not supersede this rule, so U.S. citizens and residents who receive such Australian source payments would not be subject to U.S. tax on those payments. The U.S. model treaty distinguishes between alimony payments and child support payments. Under the model treaty, alimony payments (and other maintenance payments other than child support payments) are taxable only by the country of residence of the recipient, while child support payments are taxable only by the country of the payor. The child support rule in the U.S. model, like the proposed treaty rule, is not subject to the saving clause.

At present, Australian rules provide that alimony and child support payments are neither deductible to the payor nor income to the recipient.

### Article 19. Governmental Remuneration

The proposed treaty contains the standard provision that as a general rule exempts wages of employees of one of the countries from tax in the other country. Under the proposed treaty, compensation paid by one country, its political subdivisions or their agencies or authorities, to one of its citizens for labor or services rendered in the discharge of governmental functions is taxable only by the paying country. Thus, for example, Australia would not tax the compensation of a U.S. citizen who is in Australia to perform services for the U.S. government in the discharge of governmental functions. This rule also applies to pensions paid in respect of past services. This provision is generally excluded from the saving clause for persons who are not citizens of or immigrants in the source country.

This provision of the proposed treaty is similar to the provision of the U.S. model treaty, although the U.S. model provides that the exemption does not apply to remuneration paid for services rendered in connection with a business carried on by one of the countries or by any of their political subdivisions.

### Article 20. Students

Under the proposed treaty, an individual who is a resident of one country and who is temporarily present as a full-time student in the other country will generally be exempt from tax in the host country on payments from abroad for maintenance or education. This rule also applies to a student who was a resident of one country immediately before visiting the other country. There is no precise limitation on the amount of income to which the exemption

applies. The proposed treaty does not define the term "temporarily present." The U.S. model applies this rule to students who are "present" rather than "temporarily present" in the host country. The saving clause does not apply to this article.

**Article 21. Income Not Expressly Mentioned**

This article is a catch-all article intended to cover items of income not specifically covered in other articles, and to assign the right to tax third country income to only one of the countries. It applies to income from third countries as well as income from the United States and Australia.

As a general rule, items of income not otherwise dealt with in the proposed treaty which are derived by residents of either country shall be taxable only by the country of residence. However, if the income is sourced (or is effectively connected with a permanent establishment) in the other country, it may also be taxed by that country. The source of an item of income is determined under the domestic laws of the two countries unless the treaty contains a special rule. This provision, for example, gives the United States the sole right to tax income sourced in a third country and paid to a resident of the United States. This provision is subject to the saving clause, so U.S. citizens who are Australian residents would continue to be subject to U.S. taxation on their worldwide income.

The proposed treaty would generally allow the source country to tax capital gains of residents of the other country. In this respect, the proposed treaty differs from the U.S. model, which generally allows such source country taxation only in limited circumstances (see discussion under Article 13 (Alienation of Property)).

**Article 22. Relief from Double Taxation**

***Background***

One of the two principal purposes for entering into an income tax treaty is to limit double taxation of income earned by a resident of one of the countries that may be taxed by the other country. The United States seeks unilaterally to mitigate double taxation by generally allowing U.S. taxpayers to credit the foreign income taxes that they pay against the U.S. tax imposed on their foreign source income. A fundamental premise of the foreign tax credit is that it may not offset the U.S. tax on U.S. source income. Therefore, the foreign tax credit provisions contain a limitation that ensures that the foreign tax credit offsets U.S. tax on only foreign source income. This limitation is computed on a worldwide consolidated basis. Hence, all income taxes paid to all foreign countries are combined to offset U.S. taxes on all foreign income. Separate limitations on the foreign tax credit are provided for certain interest and for DISC dividends.

A U.S. corporation that owns 10 percent or more of the voting stock of a foreign corporation may credit foreign taxes paid or deemed paid by that foreign corporation on earnings that are received as dividends (deemed paid credit). These deemed paid taxes are included in the U.S. shareholder's total foreign taxes paid for the year the dividend is received and go into the general pool of taxes to be credited.

Australia has its own set of tax provisions designed to mitigate double taxation unilaterally. In general, Australian residents are exempt from Australian income tax on income from sources in countries other than Australia if that income has been subjected to full taxation in the foreign country. In the case of non-Australian source royalty or interest income that is exempt from foreign income tax or subject to a reduced tax by treaty, and in the case of certain foreign source dividends, however, Australia generally uses a foreign tax credit system to avoid double taxation. A general rule of Australian tax law provides that tax on dividends received by certain corporate residents of Australia from any source is rebated. The rebate is calculated by determining the average rate of tax payable on the company's taxable income and applying that rate to the net income from dividends. This rebate precludes the use of foreign tax credits for the affected dividends.

Unilateral efforts to limit double taxation are imperfect. Because of differences in rules as to when a person may be taxed on business income, a business may be taxed by two countries as if it were engaged in business in both countries. Also, a corporation or individual may be treated as a resident of more than one country and be taxed on a worldwide basis by both.

Part of the double tax problem is dealt with in other articles that limit the right of a source country to tax income, and that coordinate the source rules. This article provides further relief where both Australia and the United States will still tax the same item of income. This article is not subject to the saving clause, so that the country of citizenship or residence waives its overriding taxing jurisdiction to the extent that this article applies.

The present treaty generally provides for relief from double taxation by each country permitting a credit against its tax for the appropriate amount of taxes paid to the other country on income from sources within that other country. The credit is provided, however, only to the extent permitted under certain domestic laws.

The proposed treaty provides separate rules for relief from double taxation for the United States and Australia. In addition, it provides special rules covering U.S. citizens resident in Australia.

*United States*

The proposed treaty contains the provision found in many U.S. income tax treaties that the United States will allow a citizen or resident a foreign tax credit for income taxes paid or accrued to Australia. The credit is to be computed in accordance with the provisions of and subject to the limitations of U.S.law (as those provisions and limitations may change from time to time without changing the general principles of the credit). The credit is limited to the amount of tax paid to Australia and cannot exceed the U.S. Code foreign tax credit limitations.

The proposed treaty also allows the U.S. deemed paid credit (section 902) to U.S. corporate shareholders of Australian corporations receiving dividends from those corporations if the U.S. company owns 10 percent or more of the voting stock of the Australian corporation. The credit is allowed for Australian income taxes paid by the Australian corporation on the profits out of which the dividends are paid.

This article provides that Australian income taxes covered by the treaty (Article 2 (Taxes Covered)) are considered income taxes for purposes of the U.S. foreign tax credit. Accordingly, all such Australian taxes will be eligible for the U.S. foreign tax credit. These taxes would probably be creditable for U.S. tax purposes in the absence of the proposed treaty. The treaty's special source rules do not apply for purposes of computing the limitation for other foreign taxes.

*Australia*

The proposed treaty generally provides that Australia is to credit U.S. taxes paid by Australian residents on U.S. source income. This rule applies to persons who are Australian residents under Australian tax law (i.e., including dual resident companies). This credit is not to exceed the Australian tax payable on the U.S. source income or or any class of that income or on income from non-Australian sources. Thus, if the income is exempt from Australian tax under Australian law, no credit is available. The credit is to be in accordance with the provisions and subject to the limitations of Australian law, as that law changes from time to time. The credit is not available for U.S. taxes paid by Australian residents solely because of U.S. citizenship or solely by reason of an election under U.S. law to be taxed as a U.S. resident.

The proposed treaty provides an exemption-like system for dividends received by certain Australian corporations from U.S. corporations in which they own at least ten percent of the voting power. In accordance with Australian law as of the date of signature of the proposed treaty (August 6, 1982), such a recipient Australian corporation is entitled to a rebate in its tax assessment, at its average rate of tax, of the tax attributable to such dividends received. If, however, Australia changes its internal law so as not to allow this rebate in respect of such dividends, Australia is to allow a deemed-paid foreign tax credit for U.S. tax paid on profits out of which come dividends received by Australian corporations from U.S. corporations in which they are ten-percent shareholders.

The proposed treaty provides a special rule for U.S. citizens who are Australian residents. Such persons are entitled to a credit against U.S. tax liability in the amount of the Australian tax paid. Thus, Australia generally would have taxing jurisdiction over the income of such persons as residents of Australia, subject to exemption or a credit with respect to the U.S. tax on U.S. source income. This U.S. tax credit is not to reduce U.S. taxation on a source basis of such a person's U.S. source income.

**Article 23. Nondiscrimination**

The proposed treaty contains a nondiscrimination provision relating to the taxes covered by the treaty similar to provisions which have been embodied in other recent U.S. income tax treaties. This nondiscrimination provision differs from other recent treaties and from the U.S. model in that it allows existing practices to continue, and in that it does not cover either U.S. or Australian taxes not generally covered by the proposed treaty or the taxes of States, localities, or other political subdivisions.

In general, under the proposed treaty, one country cannot discriminate by imposing more burdensome taxes (or requirements connected with taxes) on its residents who are citizens of the other country than on its residents who are also its citizens. Similarly, in general, one country cannot impose more burdensome taxes or connected requirements on permanent establishments of residents of the other country than it imposes on its comparable residents. These provisions do not, however, generally require either country to treat nonresidents as it treats residents. Thus, a country need not grant to residents of the other country the personal allowances, reliefs, or deductions for taxation purposes on account of personal status or family responsibilities that it grants to its own residents.

The rule of nondiscrimination also applies to corporations of one country which are owned in whole or in part by residents of the other country. The saving clause (which allows the country of residence or citizenship to tax notwithstanding certain treaty provisions) does not apply to this nondiscrimination article.

Each country is required (subject to the arm's-length pricing rules of Articles 9(1) (Associated Enterprises), 11(4) (Interest), and 12(5) (Royalties)) to allow a resident to deduct interest, royalties, and other disbursements paid by the resident to a resident of the other country under the same conditions that they allow deductions for such amounts paid to residents of the same country as the payor.

The provision is not intended to override the right of the United States to tax foreign corporations on their dispositions of a U.S. real property interest because the effect of the provisions imposing the tax is not discriminatory. Also, the provision is not intended to permit foreign corporations to claim the benefit of U.S. provisions intended to eliminate U.S. double tax, such as the dividends received deduction.

The proposed treaty would permit a country to continue any discriminatory tax laws in force on August 6, 1982 (the date of the signing of the treaty), to adopt any later modification of those laws that does not change their general nature, or to adopt any discriminatory laws reasonably designed to prevent tax avoidance or evasion. Any such newly adopted modification or anti-avoidance law cannot favor citizens or residents of any third country over citizens or residents of the treaty partner (the United States or Australia) of the country adopting the modification. The proposed treaty does not require that either state extend to residents of the other state benefits granted to residents of a third country by treaty, however.

Although this provision does not comport with the U.S. model treaty, Australia has never agreed to a more comprehensive nondiscrimination rule than that of the proposed treaty.

If the United States or Australia considers that the tax measures of the other country violate this nondiscrimination clause, the countries are to consult together in an endeavor to resolve the matter.

### Article 24. Mutual Agreement Procedure

The proposed treaty contains the standard mutual agreement provision which authorizes the competent authorities of both the United States and Australia to consult together to attempt to alle-

viate individual cases of double taxation not in accordance with the proposed treaty. The saving clause of the proposed treaty does not apply to this article, so that the application of this article may result in waiver (otherwise mandated by the proposed treaty) of taxing jurisdiction by the country of citizenship or residence.

Under the proposed article a resident of one country who considers that the action of the countries or either of them will cause him to pay a tax not in accordance with the treaty may present his case to the competent authority of the country of which he is a resident or citizen. The taxpayer must notify this competent authority of his case within three years from the time the taxpayer receives notice of the action he considers improper. The competent authority then makes a determination as to whether the claim has merit. If it is determined that the claim does have merit, that competent authority endeavors to come to an agreement with the competent authority of the other country to limit the taxation which is not in accordance with the provisions of the treaty.

The provision requires the waiver of the statute of limitations of either country so as to permit the issuance of a refund or credit notwithstanding the statute of limitations. The provision, however, does not authorize the imposition of additional taxes after the statute of limitations has run.

A provision directs the competent authorities to seek to resolve any difficulties or doubts arising as to the application of the convention. Specifically, they are authorized to agree to the attribution or allocation of income, deductions, credits, or allowances of an enterprise of one country to its permanent establishment in the other country (or between persons), to the determination of the source of income, to the common meaning of terms, and, for the purpose of determining residence under Article 4, to the country with which an individual has closer personal and economic relations.

The treaty authorizes the competent authorities to communicate with each other directly for purposes of reaching an agreement in the sense of the mutual agreement provision. These provisions make clear that it is not necessary to go through standard diplomatic channels in order to discuss problems arising in the application of the treaty and also removes any doubt as to restrictions that might otherwise arise by reason of the confidentiality rules of the United States or Australia.

**Article 25. Exchange of Information**

This article forms the basis for cooperation between the two countries in their attempts to deal with avoidance or evasion of their respective taxes and to enable them to obtain information so that they can properly administer the treaty. The proposed treaty provides for the exchange of information which is necessary to carry out the provisions of the proposed treaty or for the prevention of fraud or for the administration of statutory provisions concerning taxes to which the convention applies, so long as the information could be obtained under the tax laws and practices of both countries.

Information exchanged is to be treated as secret, except that it may be disclosed to persons involved in the assessment or collec-

tion of, the administration and enforcement in respect of, or litigation concerning, the taxes to which the treaty applies. The information may be used for such purposes only. Persons involved in the administration of taxes include legislative bodies involved in the administration of taxes and their agents such as, for example, the U.S. General Accounting Office, with respect to such information as they consider to be necessary to carry out their oversight responsibilities. A country is not required to supply information the disclosure of which would be contrary to public policy.

Where specifically requested, the requested competent authority will attempt to provide the information in the form requested. Specifically, the competent authority will attempt to provide copies of unedited original documents (including books, papers, statements, records, accounts, or writings) to the extent that they can be obtained under the laws and practices of the requested state in the enforcement of its own tax laws.

A requested country is to use its subpoena or summons powers or any other powers that it has under its own laws to collect information requested by the other country. It is intended that the requested country may use those powers even if the requesting country could not under its own laws. Thus, it is not intended that the provision be strictly reciprocal. For example, once the U.S. Internal Revenue Service has referred a case to the Justice Department for possible criminal prosecution, the United States investigators can no longer use an administrative summons to obtain information. If, however, Australia could still use administrative process to obtain requested information, it would be expected to do so even though the United States cannot. The United States could not, however, tell Australia which of its procedures to use.

Each country will also collect taxes for the other country, but only to the extent necessary to ensure that benefits of the treaty are not going to persons not entitled to those benefits. The provision does not require a country to collect any other taxes of the other country. The collection activities are to be carried out only in accordance with the administrative measures used by the collecting country to collect its own tax, and not in a manner contrary to its sovereignty, security, or public policy. The present treaty contains a similar collection provision.

The U.S. model treaty provides for the exchange of information about all taxes imposed by either country (whether or not otherwise covered by the treaty). The proposed treaty is more limited, applying only for enforcement of the taxes listed in Article 2 as generally covered by the treaty (generally income taxes).

**Article 26. Diplomatic and Consular Privileges**

The proposed treaty contains the rule found in other U.S. tax treaties that its provisions are not to affect the privileges of diplomatic agents or consular officials under the general rules of international law or the provisions of special agreements. Accordingly, the convention will not defeat the general exemption from tax which a host country may grant to the salary of diplomatic officials of the other country. The saving clause does not apply to this article, so that, for example, U.S. diplomats who are considered Australian residents would not be subject to Australian tax.

### Article 27. Miscellaneous

In this article, the proposed treaty provides miscellaneous rules, including primarily source rules for determining when an item of income arises in one of the countries. These source rules are used for the purpose of determining credits and exemptions under the treaty, and for determining source of income under Australian tax law. These source rules do not supersede the U.S. source of income rules for the purpose of internal U.S. law. They are not subject to the treaty's saving clause, however. Thus, the source rules may result in a waiver of taxing jurisdiction by the country of citizenship or residence.

The general source rule is that an item of income of a resident of one country that may be taxed in the other country under the treaty is considered to arise in that other country. Accordingly, income taxes paid to that other country on that income will be creditable (subject to any relevant limitations) in the country of residence.

The general source rule (described above) does not apply to income derived by an Australian resident that is taxable in the United States solely by reason of U.S. citizenship or solely by reason of an election to be treated as a U.S. resident. Such income will not be treated as U.S. source income. Income of a U.S. citizen resident in Australia is to be treated as Australian source income to the extent necessary to implement the special treaty rule of Article 22(4) (Relief from Double Taxation) that allows primary taxing jurisdiction to the United States on the U.S. source income of such a person (but at reduced treaty rates) while allowing primary taxing jurisdiction to Australia on the non-U.S. source income of such a person.

Any exemption from source basis taxation granted by one of the countries under Article 14 (Independent Personal Services), Article 15 (Dependent Personal Services), Article 17 (Entertainers), or Article 19 (Governmental Remuneration) does not apply to the extent that the income exempted under one of those articles is exempt from tax by the other country (the country of residence), whether under internal law or under the proposed treaty. The Internal Revenue Code exempts from U.S. tax certain income earned by U.S. individuals in foreign countries (sec. 911). In certain limited cases, the proposed treaty's denial of the exemption from source basis taxation would allow Australia to tax certain Australian source income of U.S. individuals that would otherwise be exempt under the treaty from Australian tax. Such income not exempt from Australian source-basis taxation would include primarily earnings from personal services of U.S. individuals who remain less than six months in Australia but spend enough time in other foreign countries to qualify under section 911.

### Article 28. Entry Into Force

The proposed treaty is subject to ratification in accordance with the applicable procedures of each country and the instruments of ratification will be exchanged as soon as possible in Washington. In general, the proposed treaty will enter into force when the instruments of ratification are exchanged.

As a general rule, the treaty will become effective for taxable years beginning on or after the first day of the second month following the date on which the proposed treaty comes into force. With respect to dividends, interest and royalties that are the subject of the treaty rules under Articles 10, 11, and 12 respectively, the treaty will be effective for amounts paid, credited, or derived on or after the first day of the second month next following the date on which the convention enters into force.

The existing treaty is to be phased out as the proposed treaty becomes effective. When the proposed treaty becomes fully effective, the existing treaty will terminate.

**Article 29. Termination**

The proposed treaty will continue in force indefinitely, but either country may terminate it at any time after five years from its entry into force by giving at least six months prior notice through the diplomatic channel.

If termination occurs, the termination will be effective with respect to dividends, interest and royalties (to which Articles 10, 11, or 12 apply) for amounts paid, credited or otherwise derived on or after the first day of January following the expiration of the six months notice. Any termination will be effective with respect to other income for taxable years beginning on or after the first day of January following the expiration of the six months notice.

The proposed treaty contains a special rule allowing either country to terminate one treaty provision in Article 18 (exempting social security payments and other public pension payments from taxation on the basis of residence and citizenship) without terminating any other provision of the treaty. Such partial termination may occur, upon prior notice through the diplomatic channel, at any time after the treaty enters into force.

## IV. REVENUE EFFECT

The treaty is expected to have a negligible effect on budget receipts.